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economic LETTER

APRIL 2011

IMPROVING PRODUCTIVITY IN CANADA: A BIG CHALLENGE

Canada clearly lags behind the United States in productivity growth. This is not news, but the gap has widened considerably since 2000 (see graph below). Productivity is a key factor in a country's ability to compete. As a small open economy, Canada must improve its productivity if it wants to remain competitive on the world stage, where competition has become much fiercer in recent years with the emergence of the Asian economies.

Several studies have been done to try to explain Canada's weak productivity growth, and many of their conclusions are similar, including serious shortcomings in Canadian business innovation, attributable in part to a decline in investment in research and development and inadequate investment in machinery and equipment, particularly information and communications technology (ICT). ICT investment is an important driver of productivity growth in the service industry, which is the predominant sector in an advanced economy like Canada's.

In 2009 the average investment in ICT per worker in Canada was only half that in the United States. Differences between the industrial structures in the two countries may partly explain this gap. For example, the proportion of companies that use ICT intensively – such as those in the information and professional, scientific and technical services sectors – is smaller in Canada than in the United States while the proportion of small companies, which invest less in ICT, is higher in Canada. The shortfall in ICT investment is, however, only one of several factors identified by the Council of Canadian Academies to explain the weakness in Canada's business innovation; others include the level of competitive intensity, the climate for new ventures, public policies that have an impact on innovation, and business ambition.[1]

Can Canada close the productivity gap with the United States? This will be no easy task, since it would require productivity growth to be higher in Canada than in the United States over a long period of time. Between 2000 and 2009, for example, productivity growth in the business sector rose 2.6% on average in the United States compared to only 0.7% in Canada. If the pace of growth ▼

[1] Conseil des académies canadiennes (2009), Innovation et stratégies d'entreprise : pourquoi le Canada n'est pas à la hauteur, Ottawa, Conseil des académies canadiennes.

Canada

> **Real GDP growth sustained**

> **Job creation slowing**

> **Housing starts rising but home sales falling**

> **Trade surplus shrinks**

United States

> **Job creation quickening slightly**

> **Housing sector still depressed**

> **Retail sales up but consumer confidence down**

Interest rates

Gap between Canadian and U.S. key interest rates could widen by one percentage point by the end of 2011

Oil and dollar

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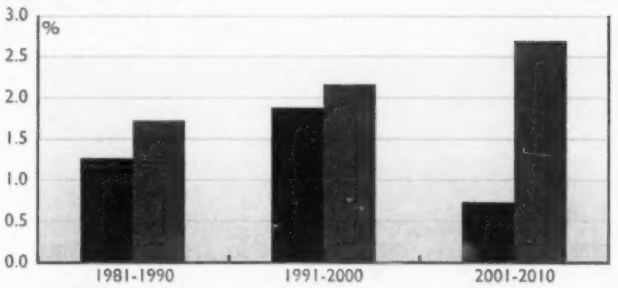
remains the same in the United States over the next 15 years, productivity growth in Canada would have to reach 4.4% per year in order to close the gap, which is 6 times higher than the average growth recorded between 2000 and 2009.

From this brief analysis it might appear that Canada is in a really bad situation. However, to put things in perspective: despite its weak productivity growth, Canada ranks tenth out of 139 countries in the World Economic Forum's Global Competitiveness rankings, with the United States coming in fourth. But if it wants to stay near the top of that list, Canada needs to get serious about tackling this problem. ■

Labour Productivity: business sector
(average annual change)



Source: Statistics Canada and U.S. Bureau of Labour Statistics

CANADA

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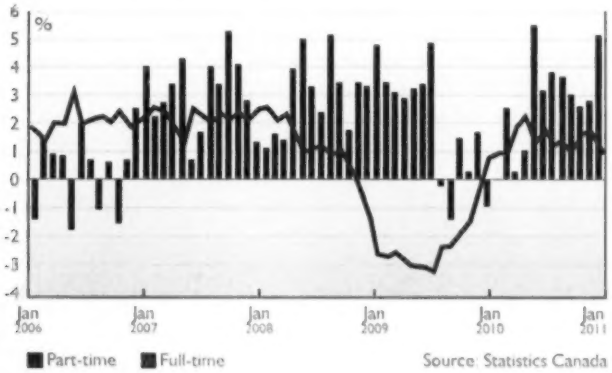
The Canadian economy is doing well: real GDP is showing sustained growth and jobs are still being created. Despite the decline in exports in January, which resulted in the evaporation of virtually the entire trade surplus posted in December, production of goods and services increased. This suggests that domestic demand is strong enough to offset weakness in foreign demand and sustain economic growth. If that proves to be the case, it would not be surprising if the Bank of Canada were to adjust its growth forecasts upward in April and raise the key interest rate before the end of the second quarter.

Job growth slowing

The change in employment was more modest in February than January but was still positive: 15,100 jobs were created compared to 69,200 a month earlier. The loss of 23,800 full-time jobs was more than offset by the creation of 38,900 part-time jobs. The unemployment rate remained unchanged at 7.8%. Part-time employment has grown much faster than full-time employment in the past 12 months, i.e. by 5.1% versus 1.1% (see graph), with the result that part-time employment rose from 19.0% of total employment in February 2010 to 19.7% in February 2011. That being said, the labour market is ticking along nicely and should support economic growth in the coming months.

Annual Change in Employment



Source: Statistics Canada

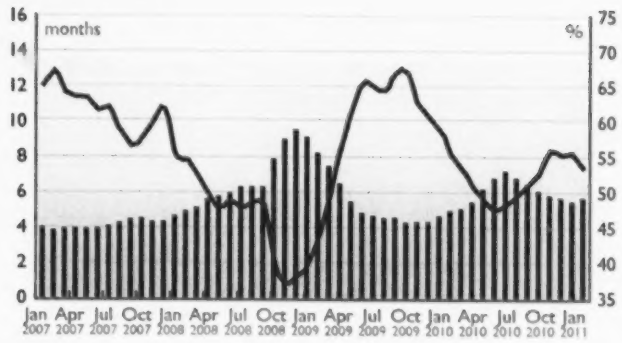
Real GDP growth sustained

Real GDP grew 0.5% in January over the previous month, following a similar increase in December. The growth in January was mainly attributable to the manufacturing sector, which saw production rise 2.8% over December, with significant increases in the production of vehicles and auto parts as well as metal parts. All the other industrial sectors–apart from mining, oil and gas, where production declined–contributed to the growth in January, but to a lesser extent than manufacturing. January's results augur well for economic growth in the first quarter.

Housing starts up but sales of existing homes down

Housing starts were up from 170,600 units in January to 181,900 in February, largely due to an increase in multiple housing starts in Ontario and the Prairies. In urban areas multiple housing starts jumped 14.5% while single family home starts were up 3.0%. On the other hand, sales of existing homes in February were down 1.7% from January and 5.9% lower than in February 2010. According to the Canadian Real Estate Association, the resale market is quite well balanced overall. The CMHC expects the number of housing starts to decline 6.5% in 2011 and increase 3.5% in 2012, and sales of existing homes to be down 1.1% in 2011 but up 4.8% in 2012. ▼

Residential market balance
(seasonally adjusted)



Source: The Canadian Real Estate Association

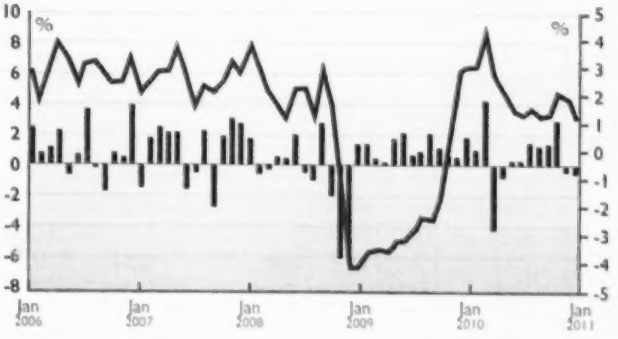
Trade surplus shrinks

As we might have expected, the improvement in the balance of trade in December was only temporary: the trade surplus fell dramatically from $1.7 G in December to $116 M in January. Exports, which had jumped 7.9% in December due to strong demand for energy products, edged up only 0.8% in January, while imports continued to grow, from 1.5% in December to 5.3% in January. Automotive and energy products accounted for much of the growth in imports but there was also a significant increase in imports of machinery and equipment. January data suggest that the contribution of foreign trade to economic growth could be weaker in the first quarter 2011 than the last quarter 2010, but with only one month of data in the quarter it is too soon to reach any firm conclusions.

Retail sales declining

Retail sales fell a further 0.3% in January, following a 0.2% decline in December. The dip in January was mainly due to a fall-off in sales of passenger cars and car parts and to lower sales in service stations. Despite this decline, retail sales were still 3.5% higher than they were in January 2010 (see graph). ■

Retail Sales



Source: Statistics Canada

★ UNITED STATES

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The most recent economic data point to the fragility of the U.S. economy: employment is growing, but slowly; consumer spending has picked up but this recovery could be short-lived because higher gas prices have shaken consumer confidence; after increasing in recent months, housing starts and sales of existing homes fell again in February, providing further evidence of persistent weakness in the housing market. Given these results, it is not surprising that forecasters do not expect any increase in the key interest rate before the end of 2011.

Job growth quickening slightly

Non-farm employment increased by 192,000 jobs in February after adding only 63,000 jobs in January. A gain of 33,000 jobs in the construction sector more than offset the 22,000 jobs lost due to bad weather the previous month. The private sector added 222,000 jobs, the twelfth consecutive monthly gain in this sector and the second largest since March 2006. However, there is still a long way to go before activity on the American job market gets back to pre-recession levels: to date, the private sector has recovered only 17% of the jobs lost since the beginning of 2008. Without a significant improvement in the labour market, there is little hope of strong economic growth.

Housing market not improving

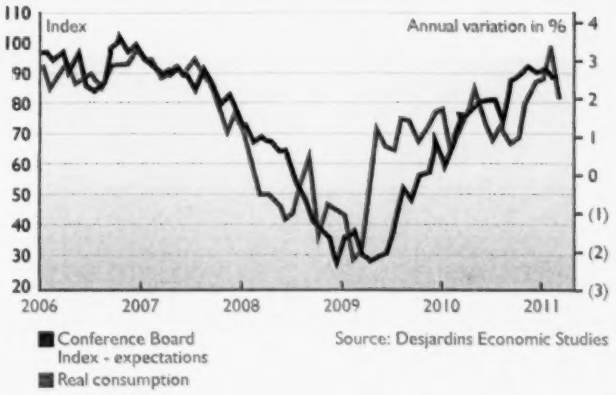
After an encouraging increase in January, housing starts fell again in February: they were 11.8% lower than in the previous month in the single family homes segment and 47% lower in the multiple units segment. In fact, single family home starts are down nearly 30% from the level a year ago. In addition, after three consecutive months of increases, sales of existing homes dropped 9.6% in February from the previous month, and the average price was 5.2% lower than it had been the previous year. Lastly, sales of new homes in February were down 16.9% from January, even after falling 9.6% in January. In short, the housing market is not improving and is expected to take many months before returning to a normal rate of growth.

Retail sales growing but consumer confidence declining

Retail sales increased in February for the third consecutive month, coming in at 1.0% higher than in January. Sales ▼

of motor vehicles were up 2.3%, their eighth gain in a row. Not including auto sales, retail sales increased 0.7% in February. However, the Conference Board Consumer Confidence Index, which had reached its highest level in three years in February, fell back sharply in March. The increase in gas prices seems to have put a damper on consumer confidence. As a result, despite the strong growth in retail sales in the first two months of the year, consumer spending may not be as strong as hoped in the first quarter of 2011. ■

Consumer Confidence Index



Source: Desjardins Economic Studies

INTEREST RATES

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Gap between Canadian and U.S. key interest rates could widen by one percentage point by the end of 2011

On March 15 the Federal Reserve left the target for the overnight rate unchanged. Since the Bank of Canada had done the same on March 1, the gap between the two key interest rates remained stable. According to the Consensus, the Fed should leave its key interest rate unchanged until the end of 2011 whereas the Bank of Canada could raise its rate by one percentage point, which would widen the gap between the two rates by the same amount. These expectations are based on the more positive economic outlook in Canada than the United States. ■

OIL AND THE LOONIE

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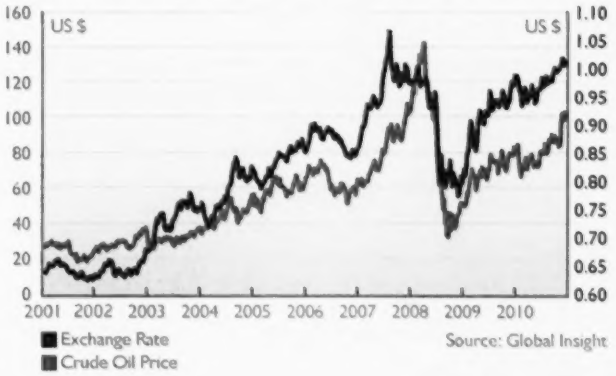
Price of oil and value of Canadian dollar still high

The price of oil remained high during the month, at above US $100 a barrel, due to ongoing instability in Libya and the danger of disruptions to oil supplies to western countries. The price of a barrel dipped slightly on hopes of an improvement in the situation, but quickly rose again when these hopes were dashed. Prices are expected to remain high and volatile as long as the situation remains unstable, which could be a long time. The Canadian dollar exchange rate moved in tandem with the price of oil, staying slightly above parity with the greenback. ■

Crude Oil Price and Canada-U.S. Exchange Rate



Source: Global Insight

BUSINESS CREDIT CONDITIONS

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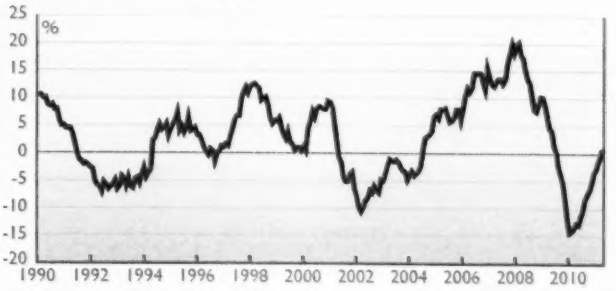
Business credit growth returns to positive territory

In February the annual growth of business credit from chartered banks returned to positive territory after being negative for 20 months since June 2009. Business credit results derived from Bank of Canada surveys – Business Outlook Survey and Senior Loan Officer Survey – pointed to an easing in credit conditions over the past few quarters. We will see if this trend continues next time the results come out in mid-April. ■

Business Credit from Chartered Banks
(year-over-year percentage change)



Source: Bank of Canada

KEY INDICATORS – CANADA

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Key indicators – Canada	Historical				2010				Latest		Forecast	
	2007	2008	2009	2010	Q1	Q2	Q3	Q4			2011	2012
Real GDP (% growth)	2.2	0.5	-2.5	[1]	5.5	2.2	1.8	3.3	Jan	0.5	2.9	2.7
Machinery and Equipment Expenditures (% growth)	4.2	-0.9	-20.3	11.2	14.8	29.7	24.6	0.7			11.2	7.9
Pre-Tax Corporate Profits (% growth)	1.9	8.0	-32.3	18.4	38.2	-6.9	0.4	41.1			13.5	8.6
Industrial Production (% growth)	-0.5	-4.5	-9.4	4.7	10.4	9.2	2.7	2.2	Jan	1.3	3.8	3.6
Industrial Product Prices (% growth)	1.5	4.3	-3.5	1.0	3.6	1.2	-1.0	6.5	Feb	0.7	3.9	2.7
Non-Residential Construction (% growth)	2.3	7.7	-19.5	-0.5	10.6	2.4	12.7	21.0				
Housing Starts (' 000 units)	228	213	148	188	198	198	179	179	Feb	182	173	179
Personal Expenditures (% growth)	4.6	2.9	0.4	3.4	4.1	1.9	2.7	4.9			2.9	2.5
Consumer Price (% growth)	2.1	2.4	0.3	1.8	2.2	-0.1	2.4	4.4	Feb	0.3	2.3	2.1
Employment (% growth)	2.4	1.7	-1.6	1.4	1.5	3.4	1.4	0.4	Feb	0.1		
Unemployment Rate (%)	6.0	6.1	8.3	-3.1	8.2	8.0	8.0	7.7	Feb	7.8	7.5	7.2
SMEs Confidence Index (CFIB)	67.2	56.1	57.7	66.7	68.4	66.7	64.7	66.7	Feb	69.4		
Manufacturers Confidence Index (CFIB)	68.8	52.7	56.0	68.6	69.7	69.0	65.7	70.2	Feb	72.3		

Sources: Statistics Canada, Consensus Economics and Canadian Federation of Independent Business. Annual growth, quarterly growth at annual rate and month-over-month growth.